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COORDINATED ISSUE
RETAIL INDUSTRY
TENANT ALLOWANCES TO RETAIL STORE OPERATORS

This paper addresses the tax consequences to a retail store operator, Company R, an accrual basis corporate taxpayer, upon its receipt of cash from a shopping mall developer in conjunction with entering into a lease. Specifically, the analysis focuses upon (1) whether Company R is in receipt of gross income, and, if so, (2) whether the retailer may exclude the payment from gross income under some provision of the Internal Revenue Code.[1]

SITUATION:
Company R, an anchor or magnet store, enters into leases with various shopping center owners/developers. Company R agrees to operate a new retail store in each developer's shopping mall. The terms of the leases range from 5 to 40 years. Company R agrees to pay annual rent for the use of the retail space. Some leases provide that the rental payments will include an amount based upon a percentage of Company R's retail sales during the lease year. The annual rent agreed to in the lease is generally based on the fair market value of the unimproved space to be occupied by Company R.

Under the terms of the leases, each developer/landlord is responsible for the completion of the gross structure of the shopping center, and Company R is responsible for the "buildout" or finishing work of the interior space it will occupy, as well as other "tenant work" such as opening for business, operating the business and advertising. The leases require the interior space to conform to certain conditions. Sometimes the landlord must approve Company R's construction plan and the completed work. A substantial portion of the buildout and other tenant work is of a nature that its economic life will not extend beyond the lease term.[2] Under the facts presented, Company R owns some of the leasehold improvements for federal tax purposes, and the landlord owns the others.[3]

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[1]Though this paper does not address the issue, the appropriateness (including timing) of any deductions claimed by a developer for payments to a retail store operator should also be examined when feasible.

[2]In many cases, the economic useful life of the buildout and tenant work is a factual issue which is not addressed in this paper.

[3]Guidance for determining ownership of the assets is contained in Discussion Section A.2.

As an inducement for entering into a lease, the developers agree to make lump sum cash payments directly to Company R. Such payments are generally timed to coincide with completion of some or all of the leasehold improvements. The amount of the cash payments may exceed the first year's rental payments, but is substantially less than the total rent due during the entire term of the lease.

ISSUE

Whether the amount of cash transferred to Company R is includible in gross income pursuant to section 61(a). Specifically (1) whether the cash payments are accessions to wealth and, if so, (2) whether Company R may exclude the cash payments from gross income under section 118 or some other provision of subtitle A of the Code.

DISCUSSION:

A. Amounts Received as Inducements to Enter Into Leases are Generally Accessions to Wealth within the Definition of Gross Income under Section 61(a).

1. General principles.

Section 61(a) provides that gross income means "all income from whatever source derived" except as otherwise provided in subtitle A of the Internal Revenue Code. Construing similar language in the 1939 Code, the United States Supreme Court in Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955), held that the statutory language evidenced Congress's intent to tax all gains except those specifically exempted. Id. at 430. The court concluded that recoveries of certain punitive damages were taxable gains, because they constitute "undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." Id. at 431.

Generally, the receipt of cash results in an accession to wealth, notwithstanding that some provision of the Internal Revenue Code may exclude the items from the section 61(a) definition of gross income, if the taxpayer receives the amount in its own behalf and there is no offsetting liability to repay the amounts or to make some other payment. See United States v. Rochelle, 384 F.2d 748 (5th Cir. 1967), cert. denied, 390 U.S. 946 (1968) (loan proceeds do not constitute income because of the offsetting obligation to repay); Rev. Rul. 76 96, 1976 1 C.B. 23 (amounts paid as rebates by an automobile manufacturer to induce qualifying retail customers to purchase its cars are treated as adjustments to purchase price.)

Incentive payments of the type described herein have been treated as accessions to wealth. For example, in John B. White, Inc. v. Commissioner, 55 T.C. 729, (1971), aff'd per curiam, 458 F.2d 989 (3d Cir.), cert. denied, 409 U.S. 876 (1972), Ford Motor

Company paid the petitioner, an automobile dealer, $59,290 as an incentive for relocating its dealership. The petitioner acquired rental space in a more suitable location and spent the inducement payments on leasehold improvements. The Tax Court concluded that "Ford's incentive payment enhanced White's wealth by enabling it to acquire suitable facilities at an improved location for its dealership." Id. at 734.

2. Determining ownership of leasehold improvements; relationship of ownership to the characterization of landlord payments.

In the situation presented herein, Company R owns some leasehold improvements, and the landlord owns others. Any amounts received from the landlord and expended by Company R on assets that are owned by the landlord cannot be characterized as income to Company R. Company R bears the burden of showing the extent to which moneys received were expended on leasehold improvements owned by the landlord. However, amounts received from the landlord as lease inducements and expended by Company R as it sees fit or on specific leasehold improvements that are owned by Company R are includible in gross income unless excluded by some section of the Internal Revenue Code. Thus, in cases in which asset ownership is in issue, the following analysis must be applied.

Ownership for federal tax purposes is determined by applying the "benefits and burdens of ownership" test to the facts and circumstances surrounding the transaction. The Tax Court has refined this test to determine whether a lease should be treated as a sale for federal tax purposes. In Grodt & McKay Realty, Inc. v. Commissioner, 77 T.C. 1221 (1981), and Coleman v. Commissioner, T.C. Memo. 1987 195, aff'd, 16 F.3d 821 (7th Cir. 1994), the Tax Court set forth the following factors[4]: (1) whether legal title passes; (2) how the parties treat the transaction; (3) whether an equity interest was acquired in the property; (4) whether the contract creates a present obligation on the seller to execute and deliver a deed and a present obligation on the purchaser to make payments; (5) whether the right of possession is vested in the purchaser; (6) which party pays the property taxes; (7) which party bears the risk of loss or damage to the property; and (8) which party receives the profits from the operation and sale of the property.

In the context of leasehold improvements, certain additional factors indicate that the tenant owns such improvements, e.g., the tenant carries personal property and liability insurance on the leasehold improvements; the tenant is the beneficiary under those policies; the tenant is responsible for replacing the leasehold improvements if they

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[4]Although the transaction described herein does not involve a "lease v. sale" analysis, some of the factors used by the court in determining whether a purported lessor or lessee had the benefits and burdens of ownership will be helpful in determining whether Company R owns the leasehold improvements.

wear out prior to the end of the lease term; and, if the usefulness of the leasehold improvements extends beyond the lease term, the tenant has the remainder interest in the improvements.

To the extent the tenant holds the benefits and burdens of ownership of the leasehold improvements, then the tenant has an accession to wealth. Unless some provision of the Internal Revenue Code excludes these payments, they fall within the section 61(a) definition of gross income.

3. The cash payments transferred to Company R cannot be characterized as adjustments to rent.

The lease inducement payments made by the developers to Company R are not adjustments to the rental payments made by Company R. In determining whether a payment to a lessee is an adjustment to rent, it is helpful to analogize to cases involving sales rebates.

The standard for determining whether a payment from a seller to a purchaser is a sales discount or a payment for separate consideration is found in Pittsburgh Milk Co. v. Commissioner, 26 T.C. 707 (1956), acq., 1982 2 C.B. 2. In that case, the Tax Court concluded that amounts paid by a milk producer to buyers were sales discounts because "the intention and purpose of the allowance was to provide a formula for adjusting a specified gross price to an agreed net price." Id. at 717. Thus, what distinguishes sales discounts from payments for separate consideration is the purpose and intent of the parties.

This "purpose and intent" test has been followed in other cases. In Sun Microsystems, Inc. v. Commissioner, T.C. Memo. 1993 467, the Tax Court held that the taxpayer could deduct from sales receipts the fair market value of stock warrants it issued to a customer in connection with the customer's purchase of the taxpayer's computer workstations. This holding was based on a finding that, under the facts and circumstances, the purpose and intent of the parties was to adjust the sales price of the workstations. See also Foretravel, Inc. v. Commissioner, T.C. Memo. 1995 494 (Tax Court held that payments made to a motor home dealer by a manufacturer were sales discounts because ample evidence existed to support the finding that the parties intended to adjust the sales price of the motor homes).

The "purpose and intent" test is equally applicable to determine if a payment by a lessor to a lessee is a rent rebate. In the situation described above, no facts exist to suggest that the purpose and intent of the payment to Company R is to arrive at a "net rental." The annual rent agreed to in the lease is generally based on the fair market value of the unimproved space to be occupied by Company R. In some cases, the rent payments are based on a percentage of Company R's retail sales during the year. In

either case, the parties have agreed to what they consider to be fair market rent without need for adjustment. The developer's payment is separate consideration for Company R's decision to locate at the developer's mall and operate a retail store there. In addition, the fact that the allowance is paid at, or prior to, the execution of the lease, rather than periodically as Company R pays rent, undermines the notion that these payments constitute mechanisms for adjusting rent.

Thus, the lease inducements paid by the developers to Company R are not adjustments to the rental payments made by Company R. It should be noted, however, that in actual cases it may be necessary to develop facts to determine if a developer's payment to a tenant is a rental adjustment based on the purpose and intent of the parties.

B. Amounts Received as Inducements to Enter Into a Lease Are Not Excludible Under Section 118.

The cash payments transferred to Company R are made in return for Company R's agreement to enter into leases and open and operate retail stores in the developers' malls. As discussed below, the transfers of cash are not contributions to Company R's capital. Moreover, no other exclusionary provisions of subtitle A of the Internal Revenue Code appear to be applicable (e.g., section 102(a), which excludes gifts).

1. Section 118(a) Nonshareholder Contributions to Capital.

a. Authorities.

i. Statute, legislative history and regulations.

Section 118(a) provides that, in the case of a corporation, gross income does not include any contributions to the capital of the taxpayer. Treas. Reg. § 1.118 1 recognizes that contributions to capital may be made by shareholders and nonshareholders, and cites as examples of nonshareholder contributions those made by governmental units and civic groups.

The term "contribution to capital" is not defined in the Internal Revenue Code or regulations. However, an examination of the legislative history indicates that section 118 was intended to be a codification of existing case law. U.S. Code Cong. & Admin. News 1954, 4648; H.R. Rep. No. 1337, 83d Cong., 2d Sess. 17 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 18 19 (1954).[5] The legislative history also indicates that a

[5]In order to eliminate a double benefit that existed under the Internal Revenue Code of 1939, Congress added 362(c) to the 1954 Code to require that property contributed by

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capital contribution lies somewhere on a continuum between a gift and compensation. The contribution cannot be called a gift because the contributor expects to derive indirect benefits. Yet, anticipated future benefits are so speculative and intangible that it would be inappropriate to treat the contribution as a payment for future services. Consistent with congressional intent, the regulations provide that the exclusion does not apply to transfers of cash or property to a corporation in exchange for goods or services to be rendered by that corporation.

ii. Case law.

Three pre 1954 Supreme Court cases are relevant to a determination of the scope of the term "contribution to capital." See Edwards v. Cuba Railroad Company, 268 U.S. 628 (1925); Detroit Edison v. Commissioner, 319 U.S. 98 (1943); and, Brown Shoe v. Commissioner, 339 U.S. 583 (1950). A post 1954 Supreme Court opinion, United States v. Chicago, Burlington & Quincy Railroad Co., 412 U.S. 401 (1973), is also relevant to this inquiry. There are also two cases that apply a section 118(a) analysis to inducements paid by developers to anchor stores in order to facilitate the success of shopping centers. See Federated Dep't Stores v. Commissioner, 51 T.C. 500 (1968), aff'd, 426 F.2d 417 (6th Cir. 1970), nonacq., 1971-2 C.B. 4; and The May Department Stores Company v. Commissioner, T.C. Memo. 1974 253, aff'd per curiam, 519 F.2d 1154 (8th Cir. 1975). The final case relevant to the scope of section 118(a) is John B. White, Inc. v. Commissioner, 55 T.C. 729 (1971), aff'd per curiam, 458 F.2d 989 (3d Cir.), cert. denied, 409 U.S. 876 (1972).

In Cuba Railroad Company, the Supreme Court held that cash subsidies paid by the Republic of Cuba to induce construction and operation of a railroad did not constitute taxable income within the meaning of the Sixteenth Amendment. The Court rested its decision on two grounds. First, it recognized that the subsidies were made with the desire of achieving a broad public benefit since the payments were made to induce the construction and operation of a railroad for the service of the public. Second, it held that the subsidies arose not out of the daily operations of the railroad, but were instead received as additions to the taxpayer's operating assets to be used in the taxpayer's business.[6] This opinion has been credited with establishing an objective, functional

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nonshareholders would take a zero basis in the transferee's hands.

[6]It should be noted that Cuba Railroad was decided when the Supreme Court was defining the term "income" in a very restrictive manner. Compare Eisner v. Macomber, 252 U.S. 189, 207 (1920) (income is the gain derived from capital, from labor, or from both combined) with Glenshaw Glass (gross income includes all undeniable accessions to wealth, clearly realized and over which the taxpayer has complete dominion).

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use test to determine whether a subsidy constitutes a contribution to capital.

In Detroit Edison, a utility company charged prospective customers for the cost of constructing power line extensions. The issue before the Court concerned the appropriate method for calculating the depreciable basis of the power lines. The Court concluded that the payments in question were not contributions to capital but rather the price of service. In so holding, the Court narrowed and refined its earlier definition of a "capital contribution". It focused on the motivation behind the contribution rather than on the function of the payment. Compare Commissioner v. Arundel Brooks Concrete Corporation, 129 F.2d 762 (4th Cir. 1942) with Commissioner v. Arundel Brooks Concrete Corporation, 152 F.2d 225 (4th Cir. 1945). The Detroit Edison decision has been recognized as replacing the functional use test established by the Cuba Railroad opinion with a subjective contributor motivation test.

In Brown Shoe, the Court utilized the contributor motivation test as its benchmark. There, community groups contributed cash and property to a manufacturing company to induce the company to locate new, or expand existing, facilities in the communities. The Court held that where the contributor is a community group that is driven by a desire to improve the general well being of the community, rather than motivated by a desire to obtain a direct benefit for itself, its donations are capital contributions. The Brown Shoe Court distinguished Detroit Edison because the contributors in Detroit Edison, unlike the contributors in Brown Shoe, were future customers of the transferee.

The Court further held that since the transferors were motivated by a desire to increase the working capital of the company, the payments were capital contributions. (See also Rev. Rul. 68 558, 1968 2 C.B. 415, in which the Service applied the subjective motivation test to facts similar to those found in Brown Shoe. In that revenue ruling the citizen contributors' dominant motivation was to benefit the entire community at large.)

The three foregoing Supreme Court opinions were the judicial guideposts at the time of the decision in Federated Dep't Stores. In Federated, a land developer contributed cash and other property to a retail store operator to induce it to construct and operate an anchor store in the developer's shopping center. The Service argued that since the contributor's primary motive was to increase the value of its property, the contribution was outside the purview of section 118(a). The Tax Court held that the contribution was a section 118(a) capital contribution. In affirming, the Sixth Circuit recognized that the motive behind the developer's contribution was to enhance the value of its property. However, the court decided that the payor's expectation of future benefit was of such a speculative and intangible nature that any benefit was "indirect" and thus not a

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Consequently, if Cuba Railroad had employed the Glenshaw Glass definition of gross income, the case may have been decided differently.

payment for future services.

The court further opined that for a contribution to be considered a payment for future goods and services, the contribution had to have a reasonable nexus to the services normally performed by the recipient corporation. Finally, the court rejected the argument that a nonshareholder capital contribution can be made only by a governmental or civic group.

In John B. White, supra, a case decided shortly after Federated, the court concluded that section 118(a) was inapplicable to the subject transaction. In John B. White, Ford Motor Company made payments to a Ford dealership to induce it to relocate to a "better" neighborhood. Ford Motor Company anticipated that the move would increase the sales of Ford Motor Company products and enhance the Ford image. Thus, Ford expected to derive a direct benefit from its payment.

In denying section 118(a) treatment, the court distinguished its case from Federated on the basis of the relationship between the payment and the business venture of the recipient corporation. In John B. White, the benefit anticipated by the contributor (increased sales of Ford products and enhancement of the Ford image) had a reasonable nexus with the business the recipient corporation customarily provided (the sale of Ford products). Accordingly, the John B. White court held that the payment was not a capital contribution.

The Supreme Court revisited the nonshareholder capital contribution question in Chicago, Burlington & Quincy Railroad Co. (CB&Q). There, various governmental units donated funds to reimburse a railroad for the cost of constructing railroad crossings that were designed to expedite traffic and improve public safety. Reflecting on its earlier capital contribution cases, the Court reconciled Brown Shoe and Detroit Edison on the basis of the motivation underlying the respective transfers. When a transferor is motivated by a desire to obtain a direct, specific, and certain benefit for itself, the Court reiterated that capital contribution status is inappropriate.

In CB&Q, each transferor's motive was to benefit the community at large (through improved public safety measures). Accordingly, the payments may well have been classified as capital contributions. However, unlike the Brown Shoe and Detroit Edison decisions, the CB&Q decision did not rest here. Rather, the Court enunciated a five part test[7], the focus of which revived the long dormant functional use test first

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[7] The five part test delineated by the CB&Q Court is that:
1. It must become a permanent part of the transferee's working capital structure;
2. It may not be compensation, such as a direct payment for a specific, quantifiable service provided for the transferor by the transferee;

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enunciated in Cuba Railroad. Since the Court concluded that the recipient corporation failed to satisfy three of these five criteria, the payment was denied capital contribution status. This resulted even though the payor's motivation may well have supported a finding of capital contribution status. (See also Rev. Rul. 93 16, 1993 1 C.B. 16, in which the Service applied the Detroit Edison and Brown Shoe subjective motivation test and the CB&Q five part test to determine that an FAA grant to a corporate airport operator was a nonshareholder contribution to capital under section 118(a).)

The final case from which guidance may be drawn is May Department Stores. May involved a shopping center developer's conveyance of land to May, a retail store operator, in return for May's agreement to build and maintain an anchor store in the shopping center. The facts in May roughly parallelled those in Federated and the Tax Court decision did little more than reiterate the conclusions of the Federated court. The court held that because the benefits anticipated by the developer were so speculative and intangible they did not rise to the level of a payment for goods and services. The court refused to limit the meaning of "indirect benefits" to those enjoyed by a contributor solely as a result of its being a member of the community at large. Thus, despite the fact that the overriding and dominant motive of the contributor was to secure a financial benefit for itself, the transfer was accorded capital contribution status.

b. Applicable Principle.

In light of the above, we believe that a transfer of money does not qualify as a nonshareholder contribution to capital under section 118 if the transferor is motivated by a desire to obtain specific, quantifiable benefits. The analysis continues, and the transferee's side of the transaction must be examined, only if the transferor has the requisite motivation.

While the Supreme Court in CB&Q set forth a five part test to measure whether a transfer was a nonshareholder contribution to capital, it is clear from the fact that the Court did not overrule Detroit Edison that failure to meet the second of the five tests listed in CB&Q the transfer may not be compensation, such as a direct payment for a specific, quantifiable service provided for the transferor by the transferee will, standing alone, bar treating a transfer as a nonshareholder contribution to capital.

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3. It must be bargained for;
4. The asset transferred must foreseeably result in benefit to the transferee in an amount commensurate with its value; and
5. The asset ordinarily, if not always, will be employed in or contribute to the production of additional income and its value assured in that respect.

Thus, the critical inquiry is whether the transfer is the vehicle by which the transferor obtains direct and tangible benefits as opposed to indirect and speculative benefits.

If the transferor expects to receive only vague, uncertain, or incidental benefits, the transfer is likely a section 118(a) contribution to capital, provided it survives the remaining CB&Q indices. A transfer in furtherance of the transferor's goal of benefitting the community at large, as described in Brown Shoe, is an example of the classic section 118(a) contribution to capital.

2. The Transfers By The Developers To Company R Do Not Meet The Requirements Of Section 118(a).

a. The lease arrangements provide a direct and nonspeculative benefit to the developers.

The developers' payments to Company R are motivated by the developers' desire to have Company R open and operate retail stores in the developers' malls. By gaining Company R's commitment to open and operate a retail store in their malls, the developers are assured of annual rental payments for significant portions of the available mall space, as well as a wide array of other benefits attributable to having a well known anchor store located in their malls. The existence of leases under which base rents are payable to the developers, standing alone, is a sufficient direct benefit to take the payments outside the scope of section 118(a).

Moreover, when the rental payments are tied to a percentage of the retailers' sales, the benefits anticipated by the transferor (i.e., rental payments) have a reasonable nexus to the business customarily conducted by the retailer (i.e., retail sales). See John B. White, supra. Accordingly, the lease inducement payments fall outside the exclusion provided by section 118(a).

b. Federated and May are distinguishable

Company R may argue that the Federated and May decisions control the tax consequences of the subject transactions. In those cases, as here, the transferors believed they would achieve increased land values and higher rental potential for their portions of the shopping centers as a result of the presence of the taxpayers in the shopping centers. In May, economic analysis reports indicated definite potential for the proposed shopping center. Stipulated testimony from one economic expert expressed the opinion that the developers would benefit by having the May Company as one of their anchor stores in the shopping center. The leader of the developers testified that the land and cash was transferred to the taxpayers only in consideration of the anticipated economic benefits that the transferor would derive from the opening of the

transferees' stores. The Service argued, among other things, that the transfer constituted a payment for a specific, quantifiable service which would bring the transfer outside the scope of section 118. Yet, the courts found these benefits to be of such an intangible and speculative nature that it was inappropriate to consider them as compensation for direct and quantifiable goods or services.

In the instant case, because there are long term leasing arrangements that provide direct and nonspeculative annual benefits to the developers, the facts present a different picture from Federated and May. The presence of the leases in the situation discussed herein distinguishes Federated and May from the instant situation and neither of these cases supports treating the lease inducements made to Company R as excludible from income under section 118(a).

CONCLUSION:

The payments from the developers to Company R are accessions to wealth except to the extent used to acquire developer owned assets. As accessions to wealth, these payments must be included in Company R's gross income pursuant to section 61(a). Further, the presence of the leasing arrangements takes the payments outside the scope of section 118(a).

Company R, an accrual basis taxpayer, must take the amount of the inducement payments into income when they accrue. Company R is allowed a full cost basis in the leasehold improvements under section 1012.